No. 18438
No. 18439

United States
COURT OF APPEALS
for the Ninth Circuit

CUMMINS DIESEL SALES OF OREGON, INC., an Oregon corporation,
Plaintiff-Appellant,

vs.

UNITED STATES OF AMERICA,
Defendant-Appellee.

No. 18438

ROBERT H. WILLS and LILLIAN WILLS, husband and wife,
Plaintiffs-Appellants,

vs.

UNITED STATES OF AMERICA,
Defendant-Respondent.

No. 18439

APPELLANT'S BRIEF

Appeals from the United States District Court for the District of Oregon

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STATEMENT OF JURISDICTION

These cases were commenced in the United States District Court for the District of Oregon as civil actions against the United States to recover the sums defendant

assessed against plaintiffs as deficiencies in plaintiffs' income taxes for the years 1955 and 1956, which sums plaintiffs paid to the Collector of Internal Revenue for the District of Oregon on March 10, 1960 (R. 8, 16, 17). Plaintiffs duly filed refund claims therefor on April 5, 1960 (R. 8, 16, 17). Plaintiffs' complaints were timely filed after the refund claims were denied (R. 3, 4, 9). The complaints alleged that the deficiency assessments were arbitrary and illegal (R. 3, 4).

The statutes involved are §§ 531 through 537, Internal Revenue Code of 1954 (26 U.S.C.A. §§ 531-37) and Sec. 162, Internal Revenue Code of 1954 (26 U.S.C.A. § 162). Jurisdiction of the District Court rested on 28 U.S.C.A. §§ 1340, 1346(a)(1), 1402 and 2402 as amended by P.L. 559 (July 30, 1954). (R. 15)

Following a consolidated trial by the court, judgments were entered on October 25, 1962, in favor of plaintiffs on the remainder of their claims; and the complaints were dismissed as to all amounts sued for other than those allowed (R. 19, 35, 50). Within the 60 day period allowed by Rule 73(a) from the entry of judgment, namely on December 19, 1962, the notices of appeal were filed (R. 20, 32, 36, 42). This Court has jurisdiction by virtue of 28 U.S.C.A. §§ 1291 and 1294.

PRELIMINARY STATEMENT

The primary issue in this (Cummins) case concerns the trial court's determination that corporate plaintiff's earnings and profits in the years 1955 and 1956 were properly subjected to the penalty tax imposed on excess

corporate accumulations by § 531 of the Internal Revenue Code of 1954.

Also involved, however, is the question of whether corporate plaintiff was entitled to deduct, as an ordinary and necessary business expense, the salary paid to a nurse rendering certain services to the president of the corporation during the years in question. The trial court disallowed the deduction and, in the companion case brought and tried at the same time, ruled that such salary was properly assessed by the Commissioner as additional income to the president of the corporation who, along with his wife, is the plaintiff in that case. The companion case referred to, *Robert H. Wills, et ux vs. United States,* is also on appeal to this Court, as Case No. 18439. This Court by its order dated March 4, 1963, has permitted these two cases to be consolidated in this brief. Although separate appeals have been taken, one of the two issues in the corporate case involves the same facts and legal problem as the sole issue in Case No. 18439.

STATEMENT OF THE CASE

Cummins Diesel Sales of Oregon, Inc., the corporate plaintiff herein, was organized as an Oregon corporation in 1939 for the purpose of handling, selling, servicing and repairing diesel engines. Since the date of its incorporation it has been the licensed dealer for Cummins Engine Company, Inc., an Indiana corporation, and has held a franchise from the Cummins Engine Company to be the distributor of Cummins engines and parts in Oregon and the river counties of Washington (R. 187). At

all times relevant to this case, Robert H. Wills has been the president and principal stockholder of the Oregon company (R. 18, 29). In 1955 and 1956 he owned approximately 96% of its outstanding stock (R. 29). Corporate plaintiff has never paid any dividends to its shareholders, and during the years in question it had substantial loans outstanding to several corporations controlled by Mr. Wills (R. 29, 30). Hereafter we will refer to the corporate party as plaintiff.

Plaintiff's original office and principal place of business was located at 1225 S. E. Grand Avenue in Portland, Oregon (Tr. 13). It consisted of two small offices and a small shop (Tr. 13). There were only four employees in 1939, including Mr. Wills, and the repair work was farmed out to two mechanics (Tr. 14). The business grew rapidly, however, and by 1955 the company had nearly 100 employees (including those at several branch offices), of which about 30 were mechanics working at the Grand Avenue location (Tr. 15, 16). The shop facilities were expanded during this growing period to encompass one-half of the block at the original location (Tr. 15).

These expanded facilities were not considered adequate by the Cummins Engine Company. For some period of time prior to 1955 the Engine Company had been insisting that plaintiff obtain newer and larger quarters. This demand was backed by the threat that plaintiff would lose the Cummins dealership if it did not comply (Tr. 90). The threat was a real one since the franchise obligated plaintiff to "maintain a suitable place

of business" (Ex. 14, p. 4; Exs. 15-18). Moreover, the franchise could be terminated by the Engine Company at will (R. 18). This matter came to a head in 1955. By that time plaintiff was operating under a 6 month extension of its franchise instead of under the earlier three year agreements (Exs. 17, 18; 11, 13, 14). Plaintiff was also then in the midst of a dispute with the Engine Company regarding policy adjustments and the extent of the latter's obligations on its warranties (Tr. 20, 91). To resolve these problems, Mr. Wills took a trip to the Cummins factory in Indiana in the latter part of the year (Tr. 20). As a result of the discussions there had with the president of the Engine Company, it was agreed that plaintiff would obtain different quarters (Tr. 22).

In September 1955 a suitable new location in another part of the city of Portland became available. The property was thereupon purchased by Portland Leasing Company, a corporation controlled by Mr. Wills, and plaintiff moved to the new location under a lease in 1955. During 1955 and 1956 plaintiff loaned Portland Leasing Company money to enable the latter to acquire and improve the new property. The total so loaned during this period exceeded plaintiff's net profit after taxes for the years 1955 and 1956 (Exs. 7, 9).

Plaintiff was assessed with a deficiency in its income taxes for the calendar year 1955 in the amount of $33,301.71 and was further assessed $18,937.81 for income tax deficiencies in the year 1956 (R. 16). Those sums were paid and, after refund claims therefor had been denied, plaintiff filed the complaint herein to recover them (R. 2, 16).

The greater part of the deficiency assessed for each of the two years in question was attributable to the Commissioner's applying the accumulated earnings tax provided by Section 531 of the Internal Revenue Code of 1954. Plaintiff's net profit after taxes in 1955 was $94,754. In 1956 its net profit after taxes was $61,548 (Ex. 7). No part of those sums was distributed as dividends to plaintiff's stockholders, and the entire amount (after minor adjustments by the Commissioner to account for capital gains as required by § 535) was assessed at the penalty rate established by § 531 (Tr. 137-38).

Also included in each deficiency assessed was a sum resulting from the disallowance of certain deductions claimed by plaintiff as ordinary and necessary business expenses. Those expenses consisted of: (1) the salary paid to the nurse who accompanied the corporation's president, Robert H. Wills, on his business trips during 1955 and 1956; and (2) certain travel expenses and club dues. Only the salary deduction is an issue here, and by comparison with the amounts involved under the excess accumulation tax issue, it is a relatively minor one. Thus, the deduction claimed by plaintiff for the nurse's salary in 1955 was $250; for the year 1956 it was $1,850 (R. 16, 17). As pointed out in the Preliminary Statement, the amounts disallowed as deductions were assessed as additional income to Mr. Wills and form the basis for his refund claim, which is on appeal to this Court in Case No. 18439.

Both the excess earnings tax issue and the nurse's salary issue are here on challenges to certain findings of fact and conclusion of law made by the trial court.

SPECIFICATIONS OF ERROR

Re: Accumulated Earnings Tax

I

The court clearly erred in finding (Finding of Fact No. XII, R. 31) that the reason for plaintiff's accumulation of earnings and failure to pay dividends was that such payment would have substantially increased the tax liability of Mr. Wills.

II

The court clearly erred in finding (Finding of Fact No. XV, R. 32) that plaintiff unnecessarily accumulated its earnings and profits in 1955 and 1956 and in finding (Finding of Fact No. XVI, R. 32) that plaintiff was availed of for the purpose of avoiding the income tax with respect to its shareholders in those years.

III

The court erred in concluding (Conclusion of Law No. II, R. 33) that the accumulated earnings tax assessed against plaintiff for 1955 and 1956 was proper.

Re: Services of the Nurse

IV

The court clearly erred in finding (Finding of Fact No. XX, R. 32) that the amounts plaintiff paid to Mr. Wills' nurse were not ordinary and necessary business expenses of plaintiff, and further erred in concluding (Conclusion of Law No. III, R. 33) that no deduction is allowable to plaintiff for the amounts so paid.

V

The court clearly erred in finding (R. 16) and in concluding (R. 17) that salary paid in 1955 and 1956 by Cummins Diesel Sales of Oregon, Inc., to the nurse who accompanied the president, Mr. Wills, on business trips in those years was a constructive dividend to Mr. Wills.

BURDEN OF PROOF

It is recognized that Rule 52(a) of the Federal Rules of Civil Procedure provides that findings of fact shall not be set aside unless "clearly erroneous." As stated in another "Accumulated earnings tax" case, however, the burden of proving a finding clearly erroneous is met when, although there is evidence to support the finding, the reviewing court is left with the definite and firm conviction that a mistake has been made. *R. Gsell & Co. v. Commissioner,* 294 F.2d 321 (2d Cir. 1961). The same rule has been announced by the United States Supreme Court, in *United States v. U.S. Gypsum Co.,* 333 U.S. 364, 395 (1948), and by this Court, in *Grace Bros. v. Commissioner,* 173 F.2d 170 (9th Cir. 1949).

Although plaintiff believes that what is denoted as Finding of Fact XVI (R. 32) was clearly erroneous, and will attempt to so prove, it does not wish to be held to this high burden of proof unnecessarily. It is therefore urged that that so-called "finding" (that plaintiff corporation was availed of to avoid taxes to its shareholders) is, under the circumstances here present, actually a con-

clusion of law, to which the "clearly erroneous" rule does not apply. *Plomb Tool Co. v. Sanger,* 193 F.2d 260 (9th Cir. 1951) *cert. den.* 343 U.S. 919 (1952). If not a conclusion of law, Finding No. XVI is a mixed question of law and fact, and again the "clearly erroneous" rule does not apply. *Bogardus v. Commissioner,* 302 U.S. 34, 39 (1937); *Chandler v. U.S.,* 226 F.2d 403 (7th Cir. 1955). With such mixed questions, the appellate court has the right to review the entire record and, in light of all the evidence, substitute its findings and conclusions for those of the district court if it finds that court's conclusion is contrary to the weight of the evidence. *Weible v. U.S.,* 244 F.2d 158 (9th Cir. 1957).

ARGUMENT

I

The Accumulated Earnings Tax Was Improperly Assessed

(a) The Primary Issue

Plaintiff's primary contention here is directed against Finding of Fact No. XV, which states that the corporation accumulated its earnings and profits beyond the reasonable needs of its business in 1955 and 1956. Two other findings are also challenged, as is the conclusion of law that the assessment of the accumulated earnings tax was proper. But in our view, the finding of unreasonable accumulation is really the key to the case, for reasons which will now be stated.

Reference to Appendix A will disclose that Section 531 of the 1954 Code imposes a tax upon the "accumu-

lated taxable income" of every corporation which is availed of for the tax avoidance purpose proscribed by § 532. Accumulated taxable income is defined in § 535 as being the taxable income (as adjusted) minus the dividends paid deduction and the "accumulated earnings credit". The accumulated earnings credit is, in turn, defined in § 535(c) as including, in the case of a corporation other than a mere holding or investment company, "an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business" (minus a deduction not here relevant). In other words, earnings and profits which are reasonably needed in the business are excluded from "accumulated taxable income" and hence, by definition, are not subject to the accumulated earnings tax imposed by § 531.

Where, as here, the corporation contends that all its earnings and profits accumulated in the years in question were reasonably needed in the business, an affirmative finding to that effect would clearly be at odds with another finding that the tax avoidance purpose existed, and would further be entirely incompatible with a conclusion that assessment of the penalty tax was proper. If all the earnings and profits were reasonably necessary for the needs of the business in the years in question, it is simply a contradiction of statutory terms to speak of a tax avoidance purpose in those years. Accordingly, if plaintiff prevails on its primary assertion that the court erred in finding an unreasonable accumulation of earnings and profits in 1955 and 1956,

that part of the judgment pertaining to the excess accumulation assessment should be reversed.

Stated in another way, plaintiff acknowledges that the ultimate question is whether the corporation was availed of "for the purpose of avoiding the income tax with respect to its shareholders" within the meaning of § 532, and further recognizes that the trial court has made an adverse finding on this ultimate issue. But when the entire record is considered, including the court's opinion, it is aparent that the so-called "finding" of the proscribed purpose is really based upon the court's prior finding that there was an unreasonable accumulation. So regarded, Finding of Fact XVI is nothing more than a statement of the conclusion of law that, by virtue of § 532, presumptively follows when an unreasonable accumulation exists.

A further matter should be mentioned in this regard. Although it might be possible for the government to argue that even if the unreasonable accumulation finding be knocked out, the judgment could nevertheless stand on the basis of the prohibited purpose finding, we believe that such an affirmance would not only be illogical but would also be contrary to the holding in *Young Motor Co. v. Commissioner,* 281 F.2d 488 (1st Cir. 1960). In that case the Tax Court was reversed for finding the prohibited purpose without giving consideration to the "subsidiary matter" of whether the accumulations were reasonably needed in the taxpayer's business.

(b) The Accumulations Were Needed in the Business

A reading of Mr. Wills' deposition and the testimony of the various witnesses called by plaintiff, all of whom were familiar with the company's business, will disclose many reasons for plaintiff's retention of earnings and profits over the years. The primary reason for the accumulation of capital, it will be seen, was to enable the company to grow as it did. Thus it was several times stated that there was a need for more operating capital as sales increased (Tr. 27, 28, 89, 94). Expansion of the business of course required plaintiff to carry larger inventories and more notes and accounts receivable (Dep. 13, 14, 26). The growth of the company further made it necessary to establish several branch offices in 1945 and one in 1956 (Tr. 16). Each such office had to be furnished with a complete set of costly tools and equipment (Tr. 55).

In 1955, with a net after-tax profit of $94,754, plaintiff advanced $37,024 to Portland Leasing Co. (Exs. 7, 9). The business purpose for this loan was to enable the affiliate to purchase property suitable for plaintiff's needs and satisfactory to the Cummins Engine Company in accordance with the Engine Company's demands, as has previously been mentioned. In 1956, when its net profit after taxes was $61,548 plaintiff made a further loan of $120,748 to Portland Leasing Co. to help finance the cost of acquisition and improvement of the new property, which plaintiff was then utilizing (Exs. 7, 9). In addition to these sums (which together totaled more than plaintiff's net income in the two years here in ques-

tion), approximately $40,000 was spent by plaintiff during the 1955-56 period to install fixtures and equipment in the new plant (Tr. 24, 26). Moreover, after moving to the new location it was discovered, as had been expected, that the cost of doing business in the larger quarters was higher than at the old location (Tr. 28). Lastly, the witnesses mentioned that a recurring need for the use of capital was to take advantage of factory offers to buy large quantities of Cummins engines at special prices, for cash (Tr. 27, 28, 40). Plaintiff borrowed $100,000 from the bank for this purpose in 1955, and $350,000 therefor in 1957 (Tr. 66, 67).

A study of Exhibits 7 and 8 substantiates the statements made by the witnesses regarding the growth of the company and the consequent need for increased capital to sustain and promote that growth. Exhibit 7 contains comparative profit and loss statements for the years ending December 31, 1949 to 1958 inclusive. Exhibit 8 contains comparative balance sheets for those same years. Although the specific problem here concerns whether plaintiff was justified in retaining some $156,000 of earnings in the years 1955 and 1956, it must be recognized that those years represent but a slice in the life of a growing corporation. A proper solution requires that consideration be given to what went before and what reasonably could have been expected to come after. That, after all, is what the directors of any corporation have to do. No successful businessman planning for tomorrow would disregard the lessons taught by his balance sheets and profit and loss statements of yesterday and today. Accordingly, it is only reasonable that the record be

examined to see how and why it was that plaintiff came to accumulate the sum it had on hand January 1, 1955, the start of the period in issue.

Tracing plaintiff's economic history and record as reflected in Exhibits 7 and 8, it will be seen that although the company's business was subject to interim fluctuations, the volume of business expanded more than two and one-half times from 1949 through the end of 1956. During this same period the working capital requirements increased proportionately. This was due to the fact that, as the volume of sales went up, not only did the cost of sales rise proportionately, but also the accounts receivable rose more than three times and inventories almost doubled (Ex. 8). Accumulations to accomodate increases in inventories and accounts receivable are, of course, proper. *J. L. Goodman Furniture Co.,* 11 T.C. 530 (1948); *F. E. Watkins Motor Co.,* 31 T.C. 288 (1958).

Another factor readily apparent from Exhibit 8 is that the amount of the fixed assets tripled in this 1949-1956 period. This, likewise, required the use of capital and involved an unquestionably proper accumulation to that extent. Finally, the increase in operating expenses of the business should be noted. As shown by Exhibit 7, those expenses more than doubled during the 1949-1956 period, reaching an all time high in 1956 of almost $800,000 per year.

Recapitulating then, the record discloses that for the 1949-1956 period:

1. Sales increased more than two and one-half times;

2. Trade accounts receivable increased more than three times.

3. Inventories almost doubled; and

4. Operating expenses almost doubled.

That these factors individually and collectively would substantially increase the working capital requirements of any corporation is beyond dispute. How these various factors affected this particular business year by year is shown below.

1949. This is the beginning of the period. Retained or accumulated earnings at the end of the year totaled $96,465, including a net profit for that year of $41,317. Sales were at $1.3 million, but sales were on the increase.

1950. By the end of this year, sales had increased 50% to slightly over $2 million. Trade accounts receivable had almost doubled and inventories had also increased. The total increases in trade accounts receivable, inventories and fixed assets over the previous year amounted to some $165,000. Earnings that year which were retained in the business equalled $122,119.

1951. Sales again increased almost 50% over the previous year, rising to $2.9 million. This no doubt reflected scarcity buying stimulated by the onset of the Korean War. Accounts receivable rose slightly, inventories increased very substantially as did fixed assets. The total increase of these items was $308,000. Earnings retained in the business after payment of all taxes amounted to $94,890 for the year.

1952. This is the year that Mr. Wills became seri-

ously ill and had to visit the Mayo Clinic in connection with the brain tumor he had removed in 1953 (Tr. 129, R. 32). Mr. Wills was primarily connected with contacting customers and with the sales aspect of the business (Tr. 10). During this year of his illness sales dropped back by some $300,000. This reflected an almost identical drop in inventories. Meanwhile, however, trade accounts receivable rose some $125,000 and fixed assets were double what they were in 1949. Retained earnings for the year were $96,591. This year also reflects an increase in the cash position of the company of almost $250,000.

1953. Mr. Wills had his operation this year and was away from work for some months (Tr. 17, R. 32). Sales remained below those in 1951 and about as they had been in 1952. Accounts receivable dropped slightly and inventories increased substantially. Fixed assets remained relatively unchanged. The total increase reflected by these items was about $115,000. Retained earnings for the year were $110,654. Meanwhile, accounts payable to Cummins Engine Company, plaintiff's supplier, had almost trebled from 1959 and totaled $420,000.

1954. Mr. Wills was away from work part of this year as the result of his illness, and sales remained stable below the 1951 peak. There was a decline in accounts receivable and inventories. Fixed assets also declined. Earnings for the year were $101,523 and were retained. 1954 saw the indebtedness to Cummins Engine Co. reduced more than $340,000.

1955. Sales bounced back above the previous high

year of 1951. Inventories and accounts receivable, as well as fixed assets, increased over the previous year by a total of $119,000. Retained earnings for the year amounted to $94,754. Acquisition of the new plant facilities was begun in this year by an affiliate corporation using the funds loaned by plaintiff for that purpose. The acquisition took place over 1955 and 1956. Plaintiff's total investment in the new facilities over the two year period was $157,771.81. Plaintiff's total retained earnings for the two years was slightly under this amount.

1956. This year saw a very substantial increase in sales to an all time high. Accounts receivable, inventory and fixed assets also increased substantially over the previous year in a total amount exceeding $250,000. Retained earnings for the year amounted to $61,548, and the acquisition of the new facilities was completed.

Subsequent years reflect substantially the same trend, increasing the requirements for the company to finance trade accounts receivable and inventories, as well as fixed assets.

In 1949 plaintiff's retained earnings amounted to $96,465. Nowhere was there even a suggestion that this amount represented an unreasonable accumulation of earnings, and it must therefore be assumed that at the beginning of the ten year period the retained earnings were within the reasonable needs of the plaintiff's business. From this starting point, and taking the growth and expansion of the company year by year, it is seen that the retained earnings did no more than keep pace with the expansion of the business and the increasing require-

ments for financing customer trade accounts receivable, inventories and fixed assets. The cash or credit for handling these increases had to come from some place. The use of earnings to finance sales and inventories is not only customary but prudent. It is therefore consistent with the concept of "the reasonable needs of the business".

The conclusion that retention of plaintiff's earnings during 1955 and 1956 was proper is further justified if those years are examined in light of the decisions in *J. L. Goodman Furniture Co.*, 11 T.C. 530 (1948), and *F. E. Watkins Motor Co.*, 31 T.C. 288 (1958). In those cases the Tax Court recognized the propriety of a corporation retaining an amount of capital equal to the sum of the average notes and accounts receivablel in the years in question, plus the average inventories, plus the average operating expenses. Applying that formula to each of the questioned years individually, and then to the averaged figures for those two years, gives the following results based upon the figures found in Exhibits 7 and 8:

	1955	1956	1955-56 Averaged
Notes and Accounts Receivable	$ 442,447	$ 507,319	$ 474,883
Inventories	389,809	480,353	435,081
Operating Expenses For One Year	638,113	796,461	717,287
Total Permissible Capital	1,470,369	1,784,133	1,627,251
Capital actually Available	1,042,415	1,096,164	1,069,289

Whether viewed one year at a time or as an average, the total capital actually available to plaintiff here was thus actually less than the amounts permitted by the Tax Court's formula.

None of the subsidiary findings by the court below alters the validity of the above analysis nor requires a different conclusion than that herein expressed. Thus while it is of course true that plaintiff never distributed any taxable dividends to its shareholders, neither had the corporation in *Young Motor Co. v. Comm.*, 281 F.2d 488 (1st Cir. 1960); or in *Breitfeller Sales, Inc.*, 28 T.C. 1164 (1957). It is likewise true that Mr. Wills had on occasion borrowed from plaintiff on interest-free loans, but that also is not fatal. *F. E. Watkins Motor Co.*, 31 T.C. 288 (1958); *R. Gsell & Co.* v. *Comm.*, 294 F.2d 321 (2d Cir. 1961). Nor should any inference of impropriety be drawn from the finding (R. 31) that Mr. Wills, as president of the company, received a substantial salary and bonus in both 1955 and 1956. Counsel for the government conceded at the trial that no contention was being made that the salary was excessive (Tr. 52, 53). Moreover, the salary finding is, if anything, evidence in favor of plaintiff; the government often points to the absence of a salary, or a reasonably sufficient salary, as being an indication of an unreasonable accumulation in this type of case. Further, the fact that a dividend would have caused Mr. Wills to pay substantially greater taxes is beside the point. *R. Gsell & Co. v. Comm.*, 294 F.2d 321 (2d Cir. 1961) (wherein the court pointed out the obvious fact that a dividend by any corporation would cause any stockholder to pay more taxes unless that

stockholder had a net loss exceeding the distribution); *Young Motor Co. v. Comm.*, 281 F.2d 488 (1st Cir. 1960).

With regard to the court's notation that most of capital account consisted of capitalized earnings, in the only case that has been found where this practice was called into question it was held that capitalizing earnings is proper even if done to prevent impostion of the accumulations tax. *Chamberlin v. Comm.*, 207 F.2d 462, 465 (6th Cir. 1953). As for the loans, those to Portland Leasing Company to finance part of the acquisition and development costs of the new property were for a legitimate business purpose and were both reasonable and necessary for plaintiff's business needs. *Hansen Baking Co.*, 12 TCM 685 (1953). Loans to or investments in unrelated businesses are proper where, as here, they are treated as being the equivalent of cash and the borrower is ready and able to repay when necessary. *Kimbell Milling Co.*, 11 TCM 219 (1952); *F. E. Watkins Motor Co.*, 31 T.C. 288 (1958); *Young Motor Co.* v. *Comm.* supra; see *Footcrafters Inc.*, 19 TCM 1401 (1960); *Breitfeller Sales, Inc.*, 28 TC 1164 (1957).

On the whole it appears that plaintiff's consistently conservative policy of not permitting dividends was necessary for the continued growth of the company. As stated in *William C. DeMille Productions, Inc.*, 30 BTA 826 (1934) with respect to a predecessor of § 531, "the cited sections do not contemplate that a business should remain static; it must be assumed that any business shall have the right to grow."

II

The Sums Paid by Plaintiff to Mr. Wills' Nurse in 1955 and 1956 Were Ordinary and Necessary Business Expenses.

In the months of November and December 1955, and during the year 1956, Mr. Wills was accompanied on his out-of-town trips by an attendant who was a registered nurse. Plaintiff paid that attendant a salary of $250 in 1955 and $1850 in 1956 and deducted such amounts in its tax returns as an ordinary and necessary business expense. Those deductions were disallowed, and part of the assessment which was paid and for which the corporate action was brought represents the tax paid as a consequence (R. 2, 3).

Before turning to the matter in issue, it should first be noted that the facts as to the services rendered by the nurse are not in dispute. The argument concerns the label to be appended to those services.

In 1953 Mr. Wills had a brain tumor removed. After returning to work, and in 1955 and 1956, he required the assistance of an attendant to drive him about and to arrange his apointments. The person who performed these services on his trips away from home was a registered nurse. Her "medical" services were limited to giving him pills (which he stated he was capable of taking himself). A collection of the testimony and stipulations concerning what the nurse did, and supporting the description of those services above given, is set forth in Appendix B to this brief and will not be stated here. From the entire record, however, it can be seen that it is undisputed that what Mr. Wills needed on those trips was someone to

drive his car for him and arrange his appointments. There is no evidence that he needed a nurse.

It is true of course that the person who performed the necessary secretarial and chauffeuring functions was a nurse. It is likewise true that the reason Mr. Wills needed any attendant at all was because of his health condition (i.e., because of the impairment of his abilities due to the prior operation). But it does not follow from either or both of those facts that the assistance thereby required could properly be called "nursing". Since there was *no* evidence that it was necessary to have a nurse give Mr. Wills his pills, and since there was abundant and uncontradicted evidence that it *was* necessary to have someone perform the non-nursing services, the correct label to be applied to those services is that of "secretary" and/or "chauffeur". It should go without saying that a corporation is entitled to deduct the salary paid to its president's secretary. (See *Freemont C. Peek,* 34 BTA 402 (1936); *Albert W. Russell,* 3 TCM 817 (1944)). And no reason is perceived why the same rule should not apply to the salary of a chauffeur whose duties are to drive the company's president about on company business. By the very words of the statute, § 162(a)(1), "a reasonable allowance for salaries or other compensation for personal services actually rendered" shall be allowed as a deduction. Accordingly, since there is nothing unordinary about an employee traveling with a company officer to assist him in carrying out the company's business, and since the services here were unquestionably necessary, the court erred in finding that none of the amounts paid by plaintiff to Mr. Wills' nurse were ordinary and necessary busi-

ness expenses. Such amounts were properly deductible to the corporation and were not income to Mr. Wills.

Even if, for the sake of argument, it be conceded that the services in question were properly categorized as nursing services, the court was still in error in ruling as it did. *Allenberg Cotton Co. v. U.S.*, 61 USTC §9131 (W.D. Tenn. 1960). The facts in the Allenberg case are similar in many respects with those here. There the president of the corporation made extensive business trips accompanied by his wife. He was a diabetic and required nursing care. She had trained at a clinic in Boston and was familiar with her husband's disease, symptoms, insulin schedule and treatment. Deductions taken by the corporation for the payment of her travel expenses were disallowed by the Commissioner, who at the same time added the value of the expenditures to the taxable income of the president of the corporation and his wife. The court ruled in favor of the taxpayer, however, and held that the travel expenses paid to the wife were ordinary and necessary business expenses of the corporation and hence were deductible to the corporation.

In the instant case, of course, we are not dealing with travel expenses. But the principle is the same since, to be deductible, there must be a business purpose for the expense, whether it be for travel or for salary. Therefore, even if in our case the services rendered Mr. Wills be regarded as nursing services, the corporate plaintiff should be allowed to deduct the nurse's salary as an ordinary and necessary business expense. By the same token, that salary should not be regarded as income to Mr. Wills.

CONCLUSION

A declaration of dividends in either 1955 or 1956 would have been unsound business practice in light of the corporate plaintiff's then existing business needs and its reasonably anticipated business needs. The court's finding that the earnings and profits in those years were unreasonably accumulated was clearly erroneous in light of the record, and therefore that part of the judgment upholding assessment of the excess accumulation tax should be reversed. The corporate plaintiff was further entitled to deduct the salary paid to the nurse in 1955 and 1956, and such payments were not constructive dividends to the individual plaintiffs. Judgment to that effect should be entered.

Respectfully submitted,

GEORGE W. MEAD,
Attorney for Plaintiffs-Appellants.

APPENDIX A

Accumulated Earnings Tax
1954 Internal Revenue Code

§ 531. In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

§ 532. (a) GENERAL RULE.—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

(b) EXCEPTIONS. * * *

§ 533. (a) UNREASONABLE ACCUMULATION DETERMINATIVE OF PURPOSE.—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) HOLDING OR INVESTMENT COMPANY. * * *

§ 534. [Applies only to burden of proof in certain cases before the Tax Court.]

§ 535. (a) DEFINITION. — For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) ADJUSTMENTS TO TAXABLE INCOME.— For purposes of subsection (a), taxable income shall be adjusted as follows:

(1) TAXES.—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164(b)(6)), accrued during the taxable year or deemed to be paid by a domestic corporation under section 902(a)(1) or 960(a)(1)(C) for the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

(2) CHARITABLE CONTRIBUTIONS. * * *

(3) SPECIAL DEDUCTIONS DISALLOWED. * * *

(4) NET OPERATING LOSS. * * *

(5) CAPITAL LOSSES. — There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211(a).

(6) LONG-TERM CAPITAL GAINS.—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) * * *

(B) * * *

(7) CAPITAL LOSS CARRYOVER. * * *

(8) BANK AFFILIATES. * * *

(9) DISTRIBUTIONS OF DIVESTED STOCK. * * *

(10) SPECIAL ADJUSTMENT ON DISPOSITION OF ANTITRUST STOCK RECEIVED AS A DIVIDEND. * * *

(c) ACCUMULATED EARNINGS CREDIT.—

(1) GENERAL RULE.—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year

as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b)(6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) MINIMUM CREDIT.—The credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) HOLDING AND INVESTMENT COMPANIES. * * *

(4) ACCUMULATED EARNINGS AND PROFITS.—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563(a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

(5) CROSS REFERENCE. * * *

§ 536. [Applies only where there is a change of accounting period.]

§ 537. For purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

APPENDIX B

Summary of the Evidence Concerning the Services Performed by the Nurse

The best description of the services performed by the nurse who accompanied Mr. Wills on trips was given by Mr. Wills. Although he had recovered considerably from his operation by the time of trial so that he no longer needed an attendant to drive him about or arrange his appointments (Tr. 18, 33), he happened to be in the hospital at trial time (Tr. 33). Accordingly, his testimony was by deposition (Tr. 5). On pages 20 and 21 of his deposition is the following:

"Q. So you were only out of work there from the company for about six months?

A. About six months, yes. I wasn't working full time for awhile.

Q. But during the time then after you came back, did you have a nurse or someone coming along with you when you were traveling?

A. I always had somebody for a couple or three years taking care of my appointments, business appointments, hotel appointments, reservations.

Q. Was it also necessary to have someone along because of your condition of your health?

A. Well, I couldn't drive. I had to have somebody to drive.

Q. Well, I mean aside from any of that. For example someone to take care of you like a doctor or a nurse or someone in case you had a relapse or —

A. No. I had to have somebody handy, such as a secretary, to do that kind of work, keep track of my appointments.

Q. But a secretary wouldn't be a nurse in any sense of the word usually?

A. No.

Q. Did you have to have someone who was qualified in both capacities then?

A. Yes.

Q. So that you did have to have a nurse or someone who was medically trained to go along with you?

A. Well, I did, because I paid them less than any secretary and the secretary could do a lot of work here.

Q. Then your nurse that went along with you, was she going with you because you needed the attention, this medical care? Is that why you took her with you?

A. No. I didn't take her for medical care. I took her for appointments and driving, things like that.

Q. Principally, but then aside from that, you say that she did go along because of the necessity for medical assistance?

A. Well, if you call rubbing your back a necessity, why yes, she did that occasionally.

Q. Well, what about pills or medications and things like that?

A. Of course, I can always give the pills myself. Still take them."

Mr. Paulson also testified concerning these services. He was a director of the corporation and familiar with Mr. Wills since 1939. (Tr. 17). He stated that it was necessary for Mr. Wills to have an attendant in 1955 and 1956 to take care of his appointments and his driving on side trips as he could not drive a car (Tr. 19). According to him, Wills could dress himself and do things of that sort, but he still needed an attendant (Tr. 32). If such an attendant were a registered nurse, "that would be fine, but . . ." (Tr. 32). In his opinion, the employment of Miss Peterson was a reasonable and ordinary business expense:

"A. Because in order for Mr. Wills to carry on the business as he did, he had to have an attendant with him. He had to have someone to keep track of his appointments. He had to have someone to drive for him. He could not go out on a long trip alone. He just could not do it. He could now, but not then."

Mr. Meyer, plaintiff's accountant, also testified that Mr. Wills needed an attendant during this period to make his appointments and drive his car (Tr. 102).

The court recognized that there was no factual dispute on this issue (Tr. 104), thereupon plaintiff's counsel stated that "we concede that because of Mr. Wills' physical condition that he had to have an attendant; that it was desirable, if possible, that the attendant be a registered nurse but that she could perform secretarial duties and she made appointments, reservations, and drove the car and saw that he got places on time . . ." (Tr. 104, 105).

The final mention of this matter in the record is to be found on pages 106 through 108 of the transcript, as follows:

"THE COURT: Well, I do not want to argue this now because I am just questioning the advisability of putting on too much testimony on this point where there is really no dispute between the parties as to the facts.

MR. MEAD: I don't think there is, your Honor, much dispute. We agree pretty much on the facts. I am sorry we couldn't resolve this question in some way because it is a minor one, but I think the only exception on the expenses is this one lady, what she did in her travel expense, and we are all agreed that it was because of Mr. Wills' physical condition that this was required, this was necessary.

THE COURT: Mr. Anderson, is there any dispute that Miss Peterson made appointments, drove the car, did telephoning for him, did other things other than purely nursing services?

MR. ANDERSON: No, there is no dispute. We admit that she did some of both. She was primarily hired, I think, if Counsel will stipulate that she was primarily hired because of his health condition, that we could even excuse Miss Peterson appearing under subpoena.

MR. MEAD: If he didn't have a health condition, we would not; I would say that is true.

THE COURT: So there is a stipulation?

MR. ANDERSON: May we excuse Miss Peterson so that she may leave?

MR. MEAD: I think we are pretty much familiar with the facts, and I just want one thing with this witness who is familiar—I assume it is stipulated that Miss Peterson was a nurse; that she was employed because of Mr. Wills' condition; that she performed services such as driving automobile, making appointments, and doing general secretarial services, and I don't mean typing by that because she is not a typist—as an attendant for Mr. Wills while he was on trips.

THE COURT: In addition to doing work which was primarily of the nature of a registered nurse.

MR. ANDERSON: That is right, and giving medicines.

MR. MEAD: Well, I think, your Honor, that the facts, if they were developed, were that what she did as a registered nurse was to give him a pill or medication a time or two every day, nothing other than that.

THE COURT: Did she give any shots, anything of that kind?

MR. MEAD: Not to my knowledge.

MR. ANDERSON: Were there any shots?

(Witness Peterson: No, I did not give anything of that nature.)

THE COURT: Just pills?

(Witness Peterson: Just pills.)

MR. MEAD: That is my understanding of it, your Honor.

MR. ANDERSON: We will stipulate to that, your Honor."

Also to be considered is Ex. 37, which is a 1958 letter from a doctor at the hospital where Mr. Wills had his operation in 1953. It states that it was necessary that Mr. Wills have an attendant.

APPENDIX C

Exhibits

Plaintiff's pretrial exhibits are designated by number and identified on pages 25, 26 and 27 of the Record. At the time of trial those exhibits were all offered by plaintiff and received as evidence by the court without objection (Tr. 3, 4) except for pretrial exhibits 35, 38 and 46, which were neither offered nor admitted. (see R. 26, 27 wherethey are crossed out). The individual plaintiff's pretrial exhibits were designated by number and certified on page 14 of the Record. At the time of trial those exhibits were all offered and received by the court without objection (Tr. 3, 4) except for pretrial Exhibit No. 4 which was not offered or admitted (See R. 14).

APPENDIX D

Certificate

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

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Attorney